



Legal Office
P.O. Box 942707
Sacramento, CA 94229-2707
Telecommunications Device for the Deaf – (916) 795-3240
(916) 795-3675, FAX (916) 795-3659

December 16, 2008

AGENDA ITEM 6

TO: MEMBERS OF THE BENEFITS AND PROGRAM ADMINISTRATION COMMITTEE

- I. SUBJECT:** Governmental Plans Determination Letter Update
- II. PROGRAM:** Administration
- III. RECOMMENDATION:** The IRS has extended the time for governmental plans to file for an IRS determination letter to allow time for the IRS to answer questions raised by the governmental plans community and to resolve remaining obstacles confronting governmental plans. Staff recommends that the decision whether to prepare and file an application with the IRS for plan determination letters and whether to take advantage of the IRS voluntary correction programs in Cycle E (which begins February 1, 2010) be considered at a future meeting of the Board.
- IV. ANALYSIS:**

A. Executive Summary

In July 2008, staff briefed the Board at its offsite meeting on obtaining IRS determination letters for CalPERS' tax-qualified plans by January 31, 2009, (the last day of the governmental plans five-year remedial amendment program (Cycle C)). Staff also indicated that it would seek authority from the Board at a subsequent Board meeting to apply for a determination letter and participate in the IRS voluntary correction program. Since that time, the governmental plans community and the IRS have worked to resolve several obstacles to filing confronting governmental plans. In light of remaining unresolved issues (including the 91-day deadline for adopting any IRS-required amendments generated during the determination letter process), the IRS also implemented a one-time filing extension. Now governmental plans may file for determination

letters either in Cycle C or Cycle E (which begins February 1, 2010 and closes January 31, 2011).

Staff recommends that CalPERS take advantage of the filing deadline extension and will, at a future meeting, seek a committee recommendation for Board authority to prepare an application for determination letter and voluntary correction to be filed during Cycle E.

B. Discussion

At the July 2008 Board Offsite, staff advised that it would ask the Board to consider whether CalPERS should by January 31, 2009¹ (1) seek determination letters² for all of its tax-qualified plans³ and (2) in conjunction with seeking determination letters, utilize IRS correction programs to bring plans up to date for prior tax law changes and to address operational failures.

Since that time, the governmental plans community has been working with the IRS to address various obstacles and identify changes that will make it easier for governmental plans to file for determination letters. While some changes were implemented in July⁴, some obstacles remain, including the requirement the Board previously was briefed on that plans adopt any IRS-required amendments

¹ The time for governmental plans to file for a determination letter under Cycle C of the governmental plans five-year remedial amendment program is February 1, 2008 through January 31, 2009.

² A determination letter is a favorable ruling from the IRS stating that the terms of the retirement plan comply with applicable provisions of the Internal Revenue Code (Code), Treasury Regulations and IRS guidance.

³ If a retirement plan is "tax-qualified" under the Code Section 401(a), then participants in the plan will not be taxed when contributions are made to the plan, but rather upon receipt of benefits at retirement. A retirement plan may obtain a determination from the Internal Revenue Service (IRS) that the plan is tax-qualified and may also correct errors that would otherwise jeopardize the plan's tax-qualified status. The CalPERS' plans include the defined benefit retirement plan funded through the Public Employees' Retirement Fund (PERS Defined Benefit Plan), the Legislators' Retirement System (LRS Plan), the Judges' Retirement System (JRS I Plan), the Judges' Retirement System II (JRS II), the Supplemental Contributions Plan, and the State Peace Officers' and Firefighters' Defined Contribution Plan

⁴ Some of the changes include:

- Not requiring a single restated plan document under certain circumstances.
- Allowing the governmental plan sponsor to submit a summary of all amendments made prior to those reflected in the current version of the plan.
- Requiring a governmental plan sponsor to verify timely adoption of plan amendments only required by GUST (an acronym that stands for a series of four recent tax laws) and later law changes.
- Eliminating the requirement to provide a redlined version of the plan document comparing the old document to the current document.

within 91 days after receiving a determination letter. That issue is unlikely to be resolved by January 31, 2009, but should be resolved later in 2009.

On November 5, 2008, the IRS extended the time for governmental plans to file for determination letters, announcing⁵ that governmental plans have the option to file for determination letters under Cycle C (which began February 1, 2008 and closes January 31, 2009) or Cycle E (which begins February 1, 2010 and closes January 31, 2011).⁶ This delayed filing is a one-time option and the determination letter for a governmental plan filed in either cycle will expire at the end of the next Cycle C (January 31, 2014).

At the same time that it files for a determination letter, CalPERS may take advantage of IRS voluntary correction programs and amend the PERL to comply with various federal tax law changes that occurred prior to 1997, as well as ensure that errors in operating the plan, if any, are also corrected.

Although the IRS will provide incentives for governmental plans to file for a determination letter and voluntary compliance programs during Cycle C -- fees and sanctions will be reduced by 50% and the plans will be reviewed first by the IRS -- it is unclear how many governmental plans will take up this offer given the issues that still need to be resolved by the IRS.

C. Advantages and Disadvantages

Generally, some advantages to seeking an IRS determination letter and using the IRS correction programs to fix existing plan deficiencies include:

- Protection from retroactive disqualification for plan language deficiencies if a plan is ever audited by the IRS;
- Full access to IRS correction programs if errors occur in operating the plan;
- Evidence of tax-qualified status that can be provided to third parties (such as other retirement plans that receive rollovers from our plans or partners in investment transactions, which often request that plans certify to their tax-qualified status); and
- Confidence that a plan has met the same standards as most other retirement plans in the private and public sectors.

⁵ The announcement was in a special edition of *Employee Plan News* (<http://www.irs.gov/pub/irs-tege/se1108.pdf>).

⁶ Recognizing that obstacles remain for governmental plans, the IRS has also advised that governmental entities that submitted an application during Cycle C by November 7, 2008 may withdraw the application by written request postmarked by January 31, 2009 (the end of the Cycle C filing period).

Further advantages to seeking a determination letter during Cycle E, as opposed to Cycle C include:

- Allows time for the IRS to respond to outstanding questions regarding governmental plans;
- Gives staff an additional twelve to twenty four months to prepare the application in an orderly process; and
- Gives CalPERS the opportunity to learn from experiences of other systems that seek determination letters in Cycle C.

Generally, some drawbacks to seeking a determination letter include:

- Financial cost (including application fees to the IRS and legal fees necessary to prepare applications and obtain a favorable letter);
- Diversion of staff time in helping counsel prepare determination letter applications and respond to IRS requests; and
- Disclosure of any plan deficiencies to the IRS and some loss in control in addressing those deficiencies.

Further disadvantages to seeking a determination letter during Cycle E include:

- Audit risk exposure between the end of Cycle C and Cycle E filing date. Any audit risk can be limited to one year by filing at the beginning of Cycle E); and
- Increased cost to CalPERS of an estimated \$20,000 to \$30,000. (The IRS is offering incentives to file during Cycle C of 50% off for fees and sanctions).

While there will be an increased risk of an audit during the period between the end of the Cycle C filing period and the date of filing an application during Cycle E, it appears that the advantages of waiting to file for a determination letter during Cycle E outweigh the disadvantages of not filing for a determination letter during Cycle C, or at all. If CalPERS begins work on the application soon, it can be prepared to file at the beginning of Cycle E, thereby mitigating the risk of an audit to a one year period of time.

V. STRATEGIC PLAN:

This item is not a specific product of the strategic plan, but is part of the workload of the Legal Office.

VI. RESULTS/COSTS:

At such time as CalPERS files for a determination letter, the resulting costs will be \$1000/plan for the determination application fee and for utilizing the IRS correction programs, the maximum IRS correction fee is \$25,000.

M. JUDITH NELSON
Senior Staff Counsel

PETER H. MIXON
General Counsel